Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

SEC Scrutiny Of Non-GAAP Disclosures Likely To Continue

Law360, New York (March 28, 2017, 10:40 AM EDT) --

Bret A. Campbell

Joseph V. Moreno

J. Robert Duncan

Just over 15 years ago, the U.S. Securities and Exchange Commission heralded its first ever cease-and-desist proceedings against an issuer — Trump Hotels and Casinos — for relying on “materially misleading” non-GAAP disclosures in an earnings release.[1] Since then, the SEC’s Division of Corporation Finance has continued to apply scrutiny to the use of non-GAAP disclosures, most recently in a public comment letter to Allergan PLC issued in January 2017, which stated that the SEC planned to “consider whether additional comprehensive non-GAAP staff guidance is appropriate.”[2] With now-President Donald Trump having nominated a new chairman and poised to appoint two additional commissioners, the priorities of the SEC going forward remain unclear. However, based on recent and continuing indications by the Division of Corporation Finance, the Division of Enforcement, and Acting Chairman Michael Piwowar, non-GAAP disclosures are likely to continue to draw scrutiny and should be handled with care.

Generally Accepted Accounting Principles or Not?

Generally accepted accounting principles (GAAP) are generally accepted rules and principles used by accountants to record transactions and present financial results. In the United States, GAAP has evolved over time and consists of rules, principles and pronouncements from the Financial Accounting Standards Board and interpretative guidance and staff bulletins issued by the SEC’s Division of Corporation Finance. Publicly traded companies (issuers) in the United States are required to prepare financial statements in accordance with GAAP and to issue public financial statements that are audited and presented with an opinion of a certified public accountant.[3]

Non-GAAP disclosures (also referred to as pro forma reporting), on the other hand, include financial information that an issuer believes is more representative of its operations and results than those compiled using GAAP. Typical examples of non-GAAP disclosures include one-time charges for business combinations, or divestitures and measures such as “earnings before interest, depreciation and amortization” (EBITDA), which may better measure a company’s cash flow by disclosing earnings absent recurring noncash deductions. Management may feel that the use of these methods provides investors with a more accurate picture of the company’s financial health. Where the use of such non-GAAP disclosures can be misleading, however, is where they lack comparability to similarly situated companies and to previous and future years.

Why Use Non-GAAP Disclosures?

Non-GAAP disclosures have earned a bad reputation because they are potentially more susceptible to manipulation and thus more likely to be used to mislead investors. By definition, they do not conform to standards that ensure comparability when analyzing a firm or industry's results. Their continued existence as a "lawless" disclosure, however, is testament to their ability to provide important information when used correctly and legitimately. That is, the sole reason that non-GAAP measurements exist is to provide additional and more insightful information to investors versus what is displayed in GAAP-compliant financial statements.

In the wake of accounting scandals at Enron and WorldCom, Congress passed the Sarbanes-Oxley Act of 2002 in an effort to rein in certain controversial accounting and auditing practices.[4] In Regulation G, the SEC promulgated rules to regulate the use of non-GAAP measurements.[5] In May 2016, the SEC released updated guidance clarifying that a non-GAAP disclosure can be misleading and violate Regulation G if it excludes non-recurring charges but does not similarly exclude nonrecurring gains.[6] This highlighted the very issue that had been tripping up issuers for decades — namely, the cherry-picking of nonrecurring transactions such as the one featured in the SEC's settlement with Trump Hotels and Casinos, whereby a one-time charge of $81.4 million was excluded from earnings, but a one-time $17.2 million nonrecurring gain was included in the same pro forma earnings report.[7]

On a more technical level, the guidance also specifically addressed a prohibition on using non-GAAP per-share measures that can be used as a liquidity measure, regardless of how such disclosures are made or used in a filing.[8] Since 1973, the SEC has prohibited the use of metrics that disclose cash flow on a per-share basis for several reasons — the most fundamental being that such a disclosure may become a preferred substitute for investors seeking cash-based financial results or is simply misleading on its face because it implies that such cash flows may be available for direct distribution to shareholders.[9] Nonetheless, in several of its 2016 filings, Allergan, like many of its peers in the pharmaceutical industry, included a metric that made several large, noncash adjustments to its operating income and presented it on a per-share basis. Through several contentious comment letters, Allergan and the SEC fought over the appropriateness of the metric, culminating in the SEC taking the rare step of indicating in a comment letter to a single issuer that it would consider issuing industrywide guidance on such measures in the future.[10]

While the SEC guidance released last year is detailed and technical, the main takeaway is far from groundbreaking — non-GAAP measures must provide a better way to understand the financial results of an issuer and not be used to mislead or distort actual financial performance. While these measures are helpful and can be included subject to the SEC's guidance, the SEC requires that the corresponding GAAP-compliant disclosures must be presented with "equal or greater prominence."[11]

Recent SEC Scrutiny

The SEC has continued to focus on non-GAAP accounting disclosures through the first quarter of 2017, with more indication that the Division of Enforcement is following the lead of the Division of Corporation Finance in scrutinizing companies' use of non-GAAP metrics. It is important that practitioners have a basic understanding of non-GAAP disclosures — including how they are used appropriately by issuers to relay important information to investors — because the SEC's recent actions indicate that it is poring over filings and collecting evidence to shift from issuing comment letters to undertaking enforcement actions.[12]

For example, at the end of 2016, the Division of Enforcement's chief accountant, Michael Maloney, addressing the American Institute of Certified Public Accountants, indicated that non-GAAP disclosures are a focus of the Division of Enforcement. While he acknowledged that cooperation with his counterparts at the Division of Corporation Finance was important, where "there's enough to open an investigation, we will."[13] On Jan. 18, 2017, the SEC followed through on Maloney's words, bringing an action against MDC Partners for, among other violations, improper use of non-GAAP measures.[14]

Even without a clear signal from President Trump or his new appointees at the SEC, these three actions likely portend a continued focus on non-GAAP measures going forward. Issuers should ensure they are compliant with last year's updated SEC guidance, and attorneys should be ready to counsel their clients on responding to SEC inquiries and actions related to their non-GAAP disclosures.

Conclusion

Non-GAAP measurements serve a valid purpose, which is to improve and supplement a company's financial disclosures and provide additional comparability between periods and among firms. However, because non-GAAP disclosures are by definition unshackled from the prescriptions of GAAP, they are susceptible to potential manipulation and vulnerable to claims that they were used to mislead investors. Issuers should remain vigilant in ensuring that they are releasing only comparable and useful non-GAAP measures, or they risk adding their name to a growing list of enforcement actions brought by the SEC.

—By Bret A. Campbell, Joseph V. Moreno and J. Robert Duncan, Cadwalader Wickersham & Taft LLP

Bret Campbell and Joseph Moreno are partners and J. Robert Duncan is an associate in the global litigation group at Cadwalader Wickersham & Taft.

[1] Press Release, SEC Brings First Pro Forma Financial Reporting Case — Trump Hotels Charged With Issuing Misleading Earnings Release (Jan. 16, 2002) available at https://www.sec.gov/news/headlines/trumphotels.htm.

[2] SEC Comment Letter to Allergan PLC Re: Form 8-K Filed August 8, 2016 (Jan. 11, 2017), https://www.sec.gov/Archives/edgar/data/1578845/000000000017001061/filename1.pdf.

[3] See 17 C.F.R. § 210.1-02, Rule 4-01 Regulation S-X.

[4] Sarbanes-Oxley Act of 2002, PL 107–204, July 30, 2002, 116 Stat 745.

[5] Conditions on the Use of Non-GAAP Financial Measures, Exchange Act Release No. 33-8176 (March 28, 2003), available at https://www.sec.gov/rules/final/33-8176.htm.

[6] See generally Non-GAAP Financial Measures, Compliance and Disclosure Interpretations (May 17, 2016), at Question 100.03, available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[7] In the Matter of Trump Hotels & Casino Resorts Inc., Order Instituting Cease-and-Desist Proceedings,

Exchange Act Release No. 45287 (Jan. 16, 2002), available at https://www.sec.gov/litigation/admin/34-45287.htm.

[8] Note 6, supra,at Question 102.05.

[9] In Accounting Series Release No. 142, Reporting Cash Flow and Other Related Data, released in 1973, the SEC noted that: (1) significant questions arise as to the relevance of per-share data presented on any basis other than earnings; (2) certain figures cannot logically be related to the common shareholder without adjustment; and (3) certain aggregate financial data, while of importance to analysts and management, are not items that accrue directly to the benefit of an investor in common equity."

[10] SEC Comment Letter to Allergan PLC Re: Form 8-K Filed August 8, 2016 (Jan. 11, 2017), https://www.sec.gov/Archives/edgar/data/1578845/000000000017001061/filename1.pdf.

[11] Note 6, supra at Question 102.10.

[12] For the 12 months ended June 30, 2016, non-GAAP measures were the third most frequent topic in comment letters. See Deloitte, A roadmap to non-GAAP financial measures, available at https://www2.deloitte.com/us/en/pages/audit/articles/a-roadmap-to-non-gaap-financial-measures.html.

[13] Tatyana Shumsky, SEC Enforcement Division "Looking Closely" at Non-GAAP Violations, Wall St. J. (Dec. 6, 2016), http://blogs.wsj.com/cfo/2016/12/06/sec-enforcement-division-looking-closely-at-non-gaap-violations/.

[14] SEC Press Release, Company Settles Charges Over Undisclosed Perks and Improper Use of Non-GAAP Measures (Jan. 18, 2017), available at https://www.sec.gov/news/pressrelease/2017-21.html.
